Decision **DRAFT DECISION OF ALJ KENNEY (Mailed 3/7/2005)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Joint Application of Lynch Telephone Corporation XI, Lynch Interactive Corporation, Brighton Communications Corporation, Cal-Ore Telephone Co. (U-1006-C), and California-Oregon Telecommunications Corporation to Authorize the Acquisition of Indirect Control of Cal-Ore Telephone Co. (U-1006-C) by Lynch Telephone Corporation XI, Lynch Interactive Corporation, and Brighton Communications Corporation through their Acquisition of Control of California-Oregon Telecommunications Company.	Application 04-05-039 (Filed May 25, 2004)

DECISION GRANTING CONDITONAL AUTHORITY FOR LYNCH INTRTACTIVE CORPORATION TO ACQUIRE INDIRECT CONTROL OF CAL-ORE TELEPHONE CO. AND CAL-ORE LONG DISTANCE, INC.

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O P I N I O N

1. Summary

This Decision grants conditional authority under Pub. Util. Code § 854[1] to transfer indirect control of Cal-Ore Telephone Co. (Cal-Ore) and Cal-Ore Long Distance, Inc. (COLD) from California-Oregon Telecommunications Company (COTC) to Lynch Interactive Corporation *et al.* The authority granted by this Decision is subject to the conditions in Appendix D.

2. Procedural Background

The following parties jointly filed Application (A.) 04-05-039 on May 25, 2005: Lynch Interactive Corporation, Brighton Communications Corporation, Lynch Telephone Corporation XI (together "Lynch"), COTC, and Cal-Ore (referred to collectively hereafter as "Joint Applicants"). In A.04-05-039, the Joint Applicants request authority for Lynch Telephone Corporation XI to acquire COTC, the parent company of Cal-Ore. The Joint Applicants submitted additional information on July 30, September 24, September 27, November 24, and November 29, 2004, and on February 10 and February 14, 2005, mostly in response to rulings issued by the assigned Administrative Law Judge (ALJ). Notice of A.04-05-039 appeared in the Commission's Daily Calendar on May 28, 2004. There were no protests or other responses to the Application.

3. Description of the Joint Applicants

Cal-Ore is a small incumbent local exchange carrier (ILEC) with approximately 2,600 access lines in four exchanges located in Siskiyou and Modoc Counties. The region served by Cal-Ore consists of rural areas and small

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[1] All statutory references are to the Public Utilities Code unless otherwise indicated.

towns.[2] Cal-Ore's revenues in 2003 were $5.3 million. Cal-Ore has approximately 130 miles of fiber and 500 route miles of copper. It utilizes two Nortel DMS-10's for switching. Cal-Ore can reach approximately 75% of its customers with DSL and has more than 300 DSL subscribers.

Cal-Ore was purchased in 1950 by Bob and Marion Edgar. At first they provided service only within the town of Dorris, but over the years they built facilities to serve outlying farms and ranches. Later, the Edgars funded Cal-Ore's purchase of the telephone facilities for the town of Macdoel. In 1984 they purchased the Tulelake and Newell exchanges. Now, due to their age and health, the Edgars wish to transfer ownership of their company.

Cal-Ore is a California corporation. It is owned by COTC, which is also a California corporation. COTC's other holdings include COLD, Cal-Ore Cellular Company, Cal-Ore Wireless, Inc., and High Desert G.P. All are 100% owned by COTC, except High Desert G.P., which is jointly owned by COTC and High Desert Investment Group, LLC.[3] COTC is owned by several trusts controlled by members of the Edgar and Graham families.

Lynch Interactive Corporation (Lynch Interactive) is a publicly traded[4] telecommunications holding company based in Rye, New York. It had $87.5 million of revenues in 2003. Its subsidiary, Brighton Communications Corporation (Brighton), owns fourteen rural ILECs in nine states outside of

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[2] Cal-Ore serves the municipalities of Dorris, Macdoel, Tulelake, and Newell, which have a population of 886, 140, 1,020, and 300, respectively. (Supplement filed Sept. 27, 2004, p. 4.)

[3] A.04-05-039, Exhibit 1, Seller's Disclosure Schedule, Section 2.1(d).

[4] Lynch Interactive is traded on the American Stock Exchange under the symbol "LIC."

California.[5] These ILECs range in size from approximately 900 access lines in New Hampshire to over 13,000 in New York. As of December 31, 2004, the total access lines were 53,145. Lynch Telephone Corporation XI (Lynch XI) is a wholly-owned subsidiary of Brighton and was established to be the acquiring entity and holding company of COTC. The Joint Applicants represent that Lynch seeks to acquire COTC to ensure that Lynch's telephone business remains strong and continues to grow through the acquisition of other telephone companies.

Lynch Interactive, Brighton, and Lynch XI are all Delaware corporations. They do not conduct business in California and will not conduct business in California as a result of the transaction. COTC and its subsidiaries will continue to conduct business in California after the consummation of the transaction.

4. The Proposed Transaction

In A.04-05-039, the Joint Applicants request authority under § 854(a) for Lynch XI to purchase all of COTC's preferred and common stock for $21.2 million in cash and promissory notes. The cash portion will be $14.0 million, and the promissory notes will total $7.2 million. Lynch plans to obtain the $14.0 million of cash paid to COTC's stockholders by issuing a like amount of debt. Thus, Lynch intends to purchase COTC using 100% debt financing (i.e., $14.0 million of debt owed to third parties and $7.2 million of promissory notes given to COTC's stockholders).

The Joint Applicants represent that no material public utility assets will be sold as a result of the transaction. Cal-Ore and COLD will remain wholly-owned subsidiaries of COTC. The book value of Cal-Ore's property dedicated to public

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[5] The nine states are Iowa, Kansas, Michigan, New Hampshire, New Mexico, New York, North Dakota, Utah, and Wisconsin.

service will not be affected by the transaction. There will no change to the names of Cal-Ore and COLD, and no material changes in the operations of these companies. Nor will there be any changes to rates, terms, and conditions of the services offered by Cal-Ore and COLD. Lynch also intends to retain the current non-shareholder employees of Cal-Ore and COLD.

5. Section 854 and the Standard of Review

Application 04-05-039 requests authority to transfer indirect control of Cal-Ore and COLD. The transfer of these two public utilities is subject to § 854(a)[6] which states, in relevant part, as follows:

> **§ 854(a):** No person or corporation…shall merge, acquire, or control…any public utility…doing business in this state without first securing authorization to do so from the commission…Any merger, acquisition, or control without that prior authorization shall be void and of no effect.

The transfer of COTC's other assets and operations, including its wireless assets and operations, is not subject to § 854(a).[7]

The purpose of § 854(a) is to enable the Commission to review a proposed transaction, before it takes place, in order to take such action as the public interest may require. The Commission has broad discretion to determine whether it is in the public interest to authorize a proposed transaction pursuant to § 854(a).

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[6] A.04-05-039 is not subject to §§ 854(b), (c), and (f), since none of the parties to the transaction has gross annual California revenues exceeding $500 million.

[7] The Joint Applicants represent that Lynch will only acquire a minority interest COTC's wireless assets and operations. (Supplement filed July 30, 2004, p. 18.) Consequently, there is no transfer of control with respect to these entities that requires Commission approval pursuant to § 854(a). Further, in D.95-10-032, Ordering Paragraph (OP) 3, the Commission held that § 854 should not apply to wireless entities. If appropriate, the Joint Applicants should update the wireless registration information currently on file at the Commission with respect to COTC's wireless operations in California. (Ibid.)

Where necessary and appropriate, the Commission may attach conditions to a transaction in order to protect and promote the public interest.[8]

We will use the following criteria to decide whether the proposed transfer of control of Cal-Ore should be approved:

- Whether the proposed transaction will maintain or improve the financial condition of Cal-Ore.
- Whether the proposed transaction will maintain or improve the quality of service for Cal-Ore's customers.
- Whether the proposed transaction will maintain or improve the quality of Cal-Ore's management.
- Whether the proposed transaction will be fair and reasonable to the affected utility employees.
- Whether the proposed transaction will be fair and reasonable to a majority of the utility shareholders.
- Whether the proposed transaction will be beneficial on an overall basis to the State and local economies and to the communities served by Cal-Ore.
- Whether the proposed transaction will preserve the jurisdiction of the Commission and its capacity to effectively regulate and audit public utility operations in California.
- Whether the proposed transaction will preserve or enhance competition.

Most of the above criteria resemble those in § 854(c), which applies to large utilities. Although we are not obligated to apply the § 854(c) criteria, since A.04-05-039 does not involve the sale of a utility with at least $500 million in California revenues, these criteria provide a useful framework for analyzing the

[8] D.01-06-007, 2001 Cal. PUC LEXIS 390, *24.

proposed transaction before us here.[9] As we noted in D.97-05-092, the § 854(c) criteria were codified because they were often employed by the Commission to evaluate transactions under § 854(a).[10] We emphasize that our use of the § 854(c) criteria in this proceeding is discretionary and should not be considered as a precedent for future applications that are not otherwise subject to § 854(c).

In the next part of this Decision, we will apply the aforementioned criteria to determine if the proposed transfer of indirect control of Cal-Ore should be authorized and what conditions, if any, should attach to the transaction. We will then use a different and more lenient set of criteria to determine if the proposed transfer of indirect control of COLD should be authorized.

6. Authority to Transfer Indirect Control of Cal-Ore Telephone Co.

A. Maintain or Improve Financial Condition

1. Background

In deciding whether to authorize a proposed transfer of control of a public utility, the Commission may consider if the transaction will maintain or improve the financial condition of the utility. The purpose of this exercise is to ensure that the proposed transfer does not adversely affect the financial ability of the utility to provide safe and reliable service at reasonable rates.[11]

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[9] In A.04-05-039, the Joint Applicants contend that the proposed transaction complies with the § 854(c) criteria (A.04-05-039, pp. 8 – 11), which indicates that the Joint Applicants likewise believe these criteria are useful for analyzing the proposed transaction.

[10] 1997 Cal. PUC LEXIS 340, *32. We have repeatedly used the § 854(c) criteria to determine if it is in the public interest to authorize transactions that are subject to § 854(a) but not otherwise subject to § 854(c). (See, for example, D.01-06-007, 2001 Cal. PUC LEXIS 390, *25; D.00-06-079, *mimeo.*, pp. 13, 15; D.00-05-023, *mimeo.*, pp. 1, 18, 20; D.98-08-068, *mimeo.*, pp. 22, 24; and D.97-07-060, 73 CPUC 2d 600, 604, 608, 610.)

[11] D.01-06-007, 2001 Cal. PUC LEXIS 390, *30.

The Joint Applicants assert that the proposed transaction will maintain or improve Cal-Ore's financial condition because it will (1) provide Cal-Ore with enhanced access to capital through Lynch, and (2) enable Cal-Ore to reap cost savings by consolidating and coordinating resources with Lynch's other telephone subsidiaries. The Joint Applicants also state that there will be no increase in the Cal-Ore's rate base due to the transaction. Therefore, ratepayers will not have to fund the acquisition premium associated with the transaction.[12]

2. Discussion

Lynch plans to purchase COTC, the parent company of Cal-Ore, for $21.2 million. The purchase price is more than four times COTC's revenues in 2003 of $5.5 million.[13] Cal-Ore accounts for the vast bulk of COTC's revenues.

Lynch intends to acquire COTC using 100% debt financing. Thus, Lynch will borrow all the money used to purchase COTC. The $21.2 million of debt incurred by Lynch to purchase COTC would be in addition to COTC's existing long-term debt, which amounted to $6.5 million on December 31, 2003.[14] Cal-Ore accounts for most or all of COTC's long-term debt.[15]

The $21.2 million of debt incurred by Lynch to acquire COTC will come from two sources. First, Lynch will obtain $14.0 million of debt from third parties, such as banks. This debt could have a variable interest rate, a fixed rate, or a combination of the two. Lynch anticipates the variable interest rate will be

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[12] The acquisition premium is the excess of purchase price over book value.

[13] On December 31, 2003, COTC's total assets were $25.0 million, its total debt was $8.5 million, and its equity (i.e., assets minus liabilities) was $16.5 million. (Supplement filed July 30, 2004, Appendix E.) Cal-Ore accounts for a majority of COTC's assets and liabilities.

[14] Supplement filed July 30, 2004, Exhibit E. The $6.5 million of debt does not include $1.1 million of current liabilities and $0.9 million of deferred incomes taxes.

[15] Supplement filed July 30, 2004, Appendix F.

approximately 5%, and the fixed interest rate will be approximately 7%. The second source of debt will be $7.2 million of notes issued by Lynch to the current owners of COTC. The interest rate on these notes will be 8% for the first year, 9% for the second year, and 10% for the next three years.[16]

The ALJ issued a ruling that directed the Joint Applicants to explain how COTC, a company with $5.5 million of annual revenues, could generate enough cash to pay for $21.2 million of new debt while continuing to fund maintenance and capital expenditures at historical levels. The Joint Applicants initially refused to provide this information. After the ALJ threatened to recommend the denial of A.04-05-039, the Joint Applicants provided the following cash-flow projection for COTC and its subsidiaries:

[16] Supplement filed July 30, 2004, pp. 8 - 9.

TABLE 1 **Surplus Cash Generated by COTC Assuming (1) $14 Million of Debt, and (2) Annual Capital Expenditures of $800,000** **$ 000**					
	2005	**2006**	**2007**	**2008**	**2009**
Net Cash Flow from Operations [1]	2,805	2,769	2,732	2,694	2,655
Less: After-tax Debt Service @ 5% Interest [1]	(1,576)	(1,540)	(1,505)	(1,470)	(1,434)
= Cash Available for Capital Expenditures	1,229	1,229	1,227	1,224	1,221
Less: Capital Expenditures of $800,000 [1]	(800)	(800)	(800)	(800)	(800)
= Cash Surplus After Capital Expenditures:	**429**	**429**	**427**	**424**	**421**
Net Cash Flow from Operations [1]	2,805	2,769	2,732	2,694	2,655
Less: After-tax Debt Service @ 7% Interest [1]	(1,738)	(1,690)	(1,640)	(1,590)	(1,540)
= Cash Available for Capital Expenditures	1,067	1,079	1,092	1,104	1,115
Less: Capital Expenditures of $800,000 [1]	(800)	(800)	(800)	(800)	(800)
= Cash Surplus After Capital Expenditures:	**267**	**279**	**292**	**304**	**315**
Note 1: Source of information is Supplement filed on November 22, 2004, Appendix B.					

The Joint Applicants' cash-flow projection for COTC shown in Table 1, above, is based on Cal-Ore's 2004 test-year revenues and expenses approved by the Commission in Resolution T-16762, issued on October 30, 2003. The projected net cash flow from operations for 2005 – 2009 assumes no growth in revenues and an annual increase in expenses of 2%. Table 1 shows that in 2009, COTC will generate a net cash surplus of $421,000 if the interest rate on $14.0 million of debt is 5%, and a net cash surplus of $315,000 if the interest rate is 7%.

There are three important things to note about Table 1. First, it omits any costs for COTC's currently outstanding long-term debt of approximately $6.5 million. The Joint Applicants state that they expect to pay off this debt when the transaction is closed using COTC's cash and liquid assets.[17] COTC had $2.2 million of cash on December 31, 2003, a certificate of deposit for $1.6 million, and marketable securities in the amount of $4.5 million.[18]

Second, Table 1 omits $7.2 million of debt that Lynch will incur to purchase COTC. The omitted debt consists of the promissory notes that Lynch will issue to the current owners of COTC. When asked why this debt had been omitted, the Joint Applicants responded as follows:

> "[Table 1] does not include debt owed to the sellers because that debt will not be at the [Cal-Ore] or the [COTC] company level. The seller debt will be higher in the corporate structure at the Lynch Telephone Company XI level. [Table 1] only includes debt that will be either at the Cal-Ore or COTC level." (Email sent by the Joint Applicants to the ALJ on November 29, 2004.)

Third, Table 1 projects that capital expenditures will be $800,000 per year after COTC is acquired by Lynch. This is substantially less than Cal-Ore's historical capital expenditures. Appendix B of today's Decision shows that Cal-Ore's capital expenditures averaged $1.9 million per year during the six-year period of 1998 - 2003, and $2.9 million per year during the three-year period of 2001 – 2003.

We find the Joint Applicants' financial projection in Table 1 to be deficient because it fails to demonstrate how COTC, a company with $5.5 million of annual revenues, could generate enough cash to pay for $21.2 million of new debt while continuing to fund capital expenditures at historical levels. The only thing the Joint Applicants have attempted to show is that COTC will be able to

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[17] Supplement filed July 30, 2004, p. 10.

[18] Supplement filed July 30, 2004, Exhibit E.

generate sufficient cash to pay for $14.0 million of new debt and a level of capital expenditures substantially below historical levels.[19]

In light of the Joint Applicants' failure to provide the information requested by the ALJ, we find it necessary to prepare our own financial analysis of the transaction, which is set forth in Appendices A , B, and C of today's Decision. The purpose of our financial analysis is to determine if COTC will be able to generate sufficient cash to pay for (1) $21.2 million of debt incurred by Lynch to acquire COTC, and (2) historical levels capital expenditures. The results of our financial analysis are summarized in Tables 2 and 3 below.[20]

[19] As described in more detail, *infra*, the assigned ALJ instructed the Joint Applicants on three occasions to demonstrate how COTC and its subsidiaries could generate sufficient cash to pay for the debt used by Lynch to acquire COTC while continuing to fund capital expenditures at historical levels. Table 1, *supra*, summarizes the Joint Applicants' response.

[20] Tables 2 and 3 assume that principal and interest payments on $14.0 million of debt begin in 2006, and that interest payments (but not principal payments) on $7.2 million of debt begin in 2006. Table 1 assumes that principal and interest payments on $14.0 million of debt begin in 2005, but there are no payments whatsoever on $7.2 million of debt.

TABLE 2 **COTC Cash Surplus/(Deficit) Assuming (1) $14.0 million of Debt at 5%, and (2) $7.2 million of Debt at 8% in 2006, 9% in 2007, and 10% in 2008 & 2009** **$ 000**				
	2006	**2007**	**2008**	**2009**
COTC Net Cash Flow from Operations [1]	2,769	2,732	2,694	2,655
Less: After-tax Debt Service @ 5% Interest [1]	(1,576)	(1,540)	(1,505)	(1,470)
Less: After-tax Debt Service @ 8% - 10% Interest [2]	(351)	(395)	(439)	(439)
= Cash Available for Capital Expenditures	842	797	750	746
Cash Surplus/(Deficit) After Capital Expenditures:				
Cap. Ex = $800K (Estimated by Joint Applicants) [1]	42	($3)	($50)	($54)
Cap Ex. = $ 1,159K (6-yr. Annual Avg. Depreciation) [2]	($317)	($362)	($409)	($413)
Cap Ex. = $ 1,320K (2003 Depreciation Expense) [2]	($478)	($523)	($570)	($574)
Cap Ex. = $ 1,907K (6-yr. Annual Avg. Cap. Ex.) [2]	($1,065)	($1,110)	($1,157)	($1,161)
Cap Ex. = $ 2,921K (3-yr. Annual Avg. Cap. Ex.) [2]	($2,079)	($2,124)	($2,171)	($2,175)
Note 1: Source of information is Supplement filed on November 22, 2004, Appendix B. **Note 2**: Source of information is Appendix B of this Decision.				

TABLE 3 **COTC Cash Surplus/(Deficit) Assuming (1) $14.0 million of Debt at 7%, and (2) $7.2 million of Debt at 8% in 2006, 9% in 2007, and 10% in 2008 & 2009** **$ 000**				
	2006	**2007**	**2008**	**2009**
COTC Net Cash Flow from Operations [1]	2,769	2,732	2,694	2,655
Less: After-tax Debt Service @ 7% Interest [1]	(1,740)	(1,690)	(1,640)	(1,590)
Less: After-tax Debt Service @ 8% - 10% Interest [2]	(351)	(395)	(439)	(439)
= Cash Available for Capital Expenditures	678	647	615	626
Cash Deficit After Capital Expenditures:				
Cap. Ex = $800K (Estimated by Joint Applicants) [1]	($122)	($153)	($185)	($174)
Cap Ex. = $ 1,159K (6-yr. Annual Avg. Depreciation) [2]	($481)	($512)	($544)	($533)
Cap Ex. = $ 1,320K (2003 Depreciation Expense) [2]	($642)	($673)	($705)	($694)
Cap Ex. = $ 1,907K (6-yr. Annual Avg. Cap. Ex.) [2]	($1,229)	($1,260)	($1,292)	($1,281)
Cap Ex. = $ 2,921K (3-yr. Annual Avg. Cap. Ex.) [2]	($2,243)	($2,274)	($2,306)	($2,295)
Note 1: Source of information is Supplement Filed on November 22, 2004, Appendix B. **Note 2**: Source of information is Appendix B of this Decision.				

Tables 2 and 3 show that the $21.2 million of debt incurred by Lynch to acquire COTC will consume so much cash that there will not be enough left over to fund Cal-Ore's capital expenditures at historical levels or to replace Cal-Ore's assets as they depreciate and wear out.[21] This finding is supported by Appendix C, which shows that COTC's historical cash flow from operations during the period of 1998 – 2003 was, on average, far less than the projected "net cash flow from operations" shown in Tables 2 and 3. Thus, Tables 2 and 3 assume that COTC will generate significantly more cash in the future than it has in the past. The upshot is that if the projected cash flow shown in Tables 2 and 3 does not fully materialize, it will be even more difficult for COTC to pay for the debt incurred by Lynch to acquire COTC while continuing to replace Cal-Ore's assets as they wear out.

The Joint Applicants assert that Lynch has a history of providing good service in other states and will make the necessary investments to provide good service in California. While Lynch may have the best of intentions, Tables 2 and 3 show that Lynch will have negative cash flow from its investment in COTC if Cal-Ore's capital expenditures remain at historical levels or at a level sufficient to replace depreciating assets. Because Lynch is a publicly traded company, it is reasonable to assume that Lynch will be under pressure from its shareholders to

[21] Lynch will accumulate equity in COTC as it pays down the debt owned on its purchase of COTC. Lynch anticipates that it will be paid a dividend on its equity investment in COTC as funds are available and as allowed by creditors. (Supplement filed July 30, 2004, p. 9.)

realize positive cash flow from its investment in COTC.[22] The only way for Lynch to do so that we can perceive is to cut Cal-Ore's expenditures.[23]

For the preceding reasons, we conclude that the proposed transaction will adversely affect the financial condition of COTC and Cal-Ore. The adverse financial effects could, in turn, cause Lynch to take actions that harm the public interest. For example, Lynch may direct Cal-Ore to cut expenditures for maintenance, repairs, customer service, and/or new plant and equipment. The end result could be a deterioration of Cal-Ore's utility infrastructure and service quality. Therefore, to ensure that Lynch's acquisition of COTC is in the public interest, we will approve A.04-05-039 with the following conditions[24]:

1. Lynch and COTC shall provide Cal-Ore with sufficient equity capital to (i) maintain a reasonable and balanced capital structure, and (ii) provide service to the public that is safe, reliable, and in compliance with all applicable statutes and Commission orders.
2. Cal-Ore shall manage its finances on a stand-alone basis, independent of COTC, Lynch, and other affiliates.

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[22] Tables 2 and 3 do not include any "management fee" that Lynch charges its subsidiaries. (A.04-05-039, Exhibit 7, p. 24.) Lynch represents that it cannot ascertain the amount of the management fee at this time. (Supplement filed July 30, 2004, p. 7.)

[23] Because the Commission regulates the rates of Cal-Ore, there is little likelihood that Cal-Ore can significantly increase revenues via rate increases. It is also unlikely that Lynch will be able to harvest much additional cash from Cal-Ore through better management or synergies with Lynch's other telephone companies, as there is no evidence that Cal-Ore has been inefficiently or profligately managed heretofore.

[24] Many of the adopted conditions are similar to conditions adopted by the Commission in one or more of the following decisions: D.01-06-084, Appendix A; D.01-06-007, Appendix B; D.00-05-047, OP 2a; D.99-04-068, OP 8; D.98-06-068, attached Settlement, Item 11; D.98-03-073, Appendix B, Item IV.A; D.96-07-059, OPs 20 – 23; D.96-07-025, OP 5; D.95-12-018, OPs 5 - 7; D.95-11-024, Finding of Fact 26; D.94-09-080, OP 4; D.91-09-068, OP 1a; D.91-09-067, OP 1a; D.88-01-063, OPs 9 – 12; and D.86-03-090, OPs 12- 15.

3. Cal-Ore shall not loan money, pay a dividend, pay a management fee, or transfer other money to COTC, Lynch, or other affiliates if doing would (i) jeopardize Cal-Ore's ability to provide safe and reliable service to the public at reasonable rates, or (ii) contravene any applicable laws, including the State Constitution, the Public Utilities Code, or any Commission order, decision, decree, rule, direction, demand, or requirement.

4. Cal-Ore shall not record a premium for regulatory accounting purposes, where the premium is the excess of purchase price over book value.

5. Cal-Ore shall not recover in its rates, charges, and fees for intrastate services any costs associated with (i) the premium; (ii) the sale / purchase of COTC; (iii) negative synergies or diseconomies of scale linked to the sale / purchase of COTC; or (iv) any other negative financial impacts associated with the transaction.

6. In order to maintain Cal-Ore's utility infrastructure at its current level, Cal-Ore's capital expenditures shall equal or exceed its depreciation expense during the five-year period beginning on January 1, 2005. To provide flexibility, Cal-Ore's capital expenditures in a given year may be more or less than its deprecation expense for the year, as long as (i) the capital expenditures during any year equal at least 33% of the depreciation expense for that year, and (ii) the cumulative capital expenditures during the five-year period equal 100% of Cal-Ore's cumulative deprecation expense during the five-year period.

7. Regardless of the amount of debt that Lynch and COTC may decide to allocate to Cal-Ore, the Commission may impute a reasonable and balanced capital structure for Cal-Ore for regulatory accounting and ratemaking purposes.[25]

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[25] Capital structure is composed of long-term debt, preferred stock, and common equity. It excludes short-term debt. (D.01-02-011, Fn. 34, 2001 Cal. PUC LEXIS 224, *32; D.00-06-040, *mimeo.*, p. 10.) In D.97-04-036, Conclusion of Law 3, the Commission held that Cal-Ore's capital structure of 39.98% debt and 60.02% equity was reasonable. (71 CPUC 2d 596, *50.) Cal-Ore's capital structure on June 30, 2003, was 47.88% debt and 52.12% equity. (Supplement filed on November 22, 2004, Exhibit F.) Today's Decision takes no position on the

Footnote continued on next page

8. No later than 90 days after the transfer of control is complete, Lynch shall use COTC's and Cal-Ore's existing cash and liquid financial assets to retire all of COTC's and Cal-Ore's existing long-term debt or, alternatively, retire a portion of the debt incurred by Lynch to acquire COTC equal to COTC's and Cal-Ore's existing long-term debt.
9. Except as specified in Condition No. 8, the assets of Cal-Ore shall not be pledged to pay or guarantee the debt of Lynch or any subsidiary or affiliate of Lynch without prior approval from the Commission.

Our authority to adopt the previous conditions is well established, as is our authority to regulate a utility's financial transactions.[26]

In their comments on the draft decision, the Joint Applicants claim that Condition No. 6, *supra*, may force Cal-Ore to spend more for capital expenditures than necessary. We believe that it is more likely that Cal-Ore will spend too little for capital expenditures rather than too much. As described previously, the cost of the debt incurred by Lynch to acquire COTC will consume so much cash that there will not be sufficient cash available for Cal-Ore to fund capital expenditures at anywhere near historical levels. Therefore, to ensure that Cal-Ore's public utility infrastructure does not degrade due to diminished capital expenditures, Condition No. 6 requires Cal-Ore's capital expenditures to equal or exceed its depreciation expense for the next five years. The effect of Condition No. 6 is to require the Joint Applicants to sustain Cal-Ore's net plant-in-service at its current level. If the Joint Applicants believe that it is unnecessary to keep public utility

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reasonableness of Cal-Ore's current capital structure. In the future, Cal-Ore will have the burden of demonstrating the reasonableness of any capital structure that deviates from that found reasonable by the Commission in D.97-04-036.

[26] D.01-06-007, Cal. PUC LEXIS 390, *54

infrastructure at its current level, they should have the burden of demonstrating why the public will not be harmed by a diminished level of infrastructure.

To demonstrate that it is reasonable to spend less on capital expenditures than is required by today's Decision, Cal-Ore may file a petition to modify this Decision in 2010 to obtain after-the-fact approval of its actual capital expenditures during 2005 - 2009. Cal-Ore will have the burden of demonstrating in its petition that the decline in Cal-Ore's net plant-in-service during 2005 – 2009 was reasonable and did not harm the public interest.[27] If the Commission finds that Cal-Ore's ratepayers were harmed by Cal-Ore's decision to spend less for capital expenditures than required by today's Decision, the Commission may find that Cal-Ore has failed to comply with today's Decision and take such actions as warranted by the circumstances.

B. Maintain or Improve the Quality of Service

i. Background

In deciding whether to authorize the transfer of control of a public utility, the Commission may consider if the proposed transfer will maintain or improve the quality of service to California ratepayers.[28]

The Joint Applicants assert that Lynch, as a long-time provider of local telephone service, will be able to maintain Cal-Ore's service quality at its present level. The Joint Applicants believe that service quality may improve by sharing best practices among Lynch's utility subsidiaries. Lynch also provides its

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[27] To aid the Commission's assessment of potential harm to Cal-Ore's ratepayers, the petition shall contain the following information: (i) General Order (GO) 133-B data for each year during 2003 – 2009; (ii) total depreciation expense (interstate and intrastate) for each year during 2005 – 2009; (iii) and total capital expenditures for each year during 2005 – 2009; and (iv) cumulative depreciation expense and capital expenditures during 2005-2009.

[28] D.01-06-007, 2001 Cal. PUC LEXIS 390, *56.

telephone companies with access to technical resources that may not be available or affordable to companies like Cal-Ore. For example, Lynch provides its telephone companies with access to its Technology Group, which consolidates efforts in important areas such as local number portability and the development of Continuity or Disaster Recovery Plans. Access to such resources saves the individual telephone companies substantial time and money, and ensures that the companies meet their regulatory obligations in an efficient manner.

ii. Discussion

There is no doubt that Lynch has a wealth of telecommunications experience and expertise. We are concerned, however, that the need to pull cash out of Cal-Ore to pay for the $21.2 million of debt incurred by Lynch to acquire COTC will create a strong financial incentive to slash Cal-Ore's expenditures for maintenance, repairs, operations, and / or utility infrastructure. If this occurs, the quality of service provided by Cal-Ore could deteriorate over time.

In order to protect Cal-Ore's customers, we will approve A.04-05-039 with the condition that the transaction must have no adverse effect on Cal-Ore's service quality. We recognize that this condition cannot be easily monitored. If Cal-Ore's service quality deteriorates prior to January 1, 2010, Cal-Ore shall have the burden of demonstrating that the deterioration was not caused by, or related to, Lynch's acquisition of COTC. If we find that the acquisition has contributed to a deterioration in service quality, then Cal-Ore and Lynch may be subject to all remedies legally available to the Commission, including, but not limited to, monetary penalties under § 2107 for having violated this Decision. With the adoption of the aforementioned condition, we find that Lynch's acquisition of Cal-Ore will maintain service quality for all of Cal-Ore's customers.

C. Maintain or Improve the Quality of Management

i. Background

In deciding whether it is in the public interest to authorize the transfer of control of a public utility, the Commission considers if the new owner has adequate technical and managerial competence to continue the kinds and quality of service that customers have experienced in the past. The Commission also considers if the new owner is experienced, financially responsible, and adequately equipped to continue the business sought to be acquired.[29]

The Joint Applicants state that transaction will not change Cal-Ore's operational management, and that the change of ownership will provide Cal-Ore's management with access to a broader array of best practices. Moreover, Lynch will provide Cal-Ore with access to resources that will improve the quality of Cal-Ore's management. For example, Cal-Ore will have access to Lynch's Accounting Group, which provides expertise to the Lynch companies through teleconferences on issues such as improving accounting procedures, and to Lynch's Regulatory Group, which holds frequent calls regarding regulatory issues such as universal service and intercarrier compensation.

ii. Discussion

Lynch owns 14 rural telephone companies in nine states. These companies are similar in many respects to Cal-Ore. In light of Lynch's extensive experience in managing telephone companies like Cal-Ore, we conclude that the technical competence of Cal-Ore's management will be maintained or improved after it is acquired by Lynch.

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[29] D.01-06-007, 2001 Cal. PUC LEXIS 390, *100.

The record of this proceeding has revealed one troubling aspect about the quality of Lynch's management, namely, their unwillingness to cooperate with the Commission. On July 7, 2004, the assigned ALJ issued a ruling that directed the Joint Applicants to provide responses to the following questions:

> **Question 16**: Please provide a detailed description of how COTC and its subsidiaries will collectively generate sufficient cash…to pay for (a) the cost of capital…that is used by [Lynch] to acquire COTC, and (b) historical levels of investment and maintenance expenditures for (i) Cal-Ore and (ii) other COTC subsidiaries…
>
> **Question 17**: Please provide any projected internal rate of return, return on investment, net present value, and/or similar analyses that [Lynch] relied upon in deciding to acquire COTC.

The Joint Applicants refused to provide the information requested by the ALJ. On August 18, 2004, the assigned ALJ issued a ruling that stated as follows:

> [T]his ruling requires the Applicants to…[provide] full and complete responses to Questions 16 and 17…If the Applicants do not…[this] will be deemed good cause to impose an issues sanction on the Applicants for their noncompliance… Specifically, the…ALJ will presume certain facts, namely, that (1) the proposed transaction will negatively affect Cal-Ore's ability to serve the public, and (2) Lynch is unfit to acquire indirect control of Cal-Ore because of the Applicants' failure to comply with two ALJ rulings. With these facts in mind, the assigned ALJ will prepare…a draft decision that denies A.04-05-039.

The Joint Applicants responded to Questions 16 and 17 on September 27, 2004. The response to Question 16 was deficient in two respects. First, Question 16 instructed the Joint Applicants to show how COTC would generate enough cash to pay for the debt incurred by Lynch to acquire COTC. The record in this proceeding is clear that Lynch intends to borrow $21.2 million to purchase COTC. However, the Joint Applicants' response to Question 16 shows only $14.0 million of debt, not the $21.2 million that Lynch intends to borrow.[30] Second, Question 16 instructed the Joint Applicants to show how COTC would generate enough cash to pay for historical levels of capital expenditures. The Joint Applicants' response to Question 16 shows only $800,000 of annual capital expenditures, which is considerably below the three and six-year average for capital expenditures.[31] In sum, the Joint Applicants failed to provide full and complete responses to Question 16 as required by two ALJ rulings.

The Joint Applicants response to Question 17 was hardly better. According to the Joint Applicants, they had no information responsive to Question 17. We find it hard to believe that Lynch did not conduct any analysis of how much money it might earn or lose on its investment in COTC. The failure to do so raises troubling questions about Lynch's management. Although the Applicants did provide other information in response to Question 17, which was filed under seal, this other information was plagued with mathematical errors and was not useful to our analysis of the proposed transaction.

The ALJ made one last effort to obtain information that the Joint Applicants had failed to provide on two previous occasions. Specifically, in a ruling issued on October 26, 2004, the ALJ directed the Joint Applicants to demonstrate how COTC could generate enough cash to pay for $21.2 million of

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[30] The Joint Applicants' response to Question 16 consisted of a spreadsheet that showed the amount of cash COTC and its subsidiaries would generate and the principal and interest payments on the debt, but not the total amount of the debt. The Joint Applicants did not disclose that the principal and interest payments shown in the spreadsheet were based on $14.0 million of debt. The ALJ discovered the omission of $7.2 million of debt (and related principle and interest payments) after closely scrutinizing the spreadsheet.

[31] Supplement filed Sept. 27, 2004, p. 9.

debt incurred by Lynch to acquire COTC.[32] In their response filed on November 22, 2004, the Joint Applicants once again did not provide the information required by the ALJ. Instead of attempting to show that COTC could generate enough cash to pay for $21.2 million of debt that will be incurred by Lynch to acquire COTC, the Joint Applicants submitted spreadsheets that showed COTC could pay for $14.0 million of debt.

We believe the reason for the Joint Applicant's initial refusal and subsequent failure to provide information required by the ALJ is rooted in the fact that the proposed transaction will be 100% debt financed. As described previously, COTC will <u>not</u> generate enough cash to pay for both $21.2 million of acquisition debt and historical levels of capital expenditures. It appears that the Joint Applicants were attempting to downplay or conceal this central fact. Irrespective of inferred motive, the record of this proceeding leaves no doubt that the Joint Applicants willfully disregarded repeated ALJ rulings to provide material and relevant information.

In light of the Joint Applicants' lack of cooperation, we harbor serious reservations about granting Lynch authority to assume indirect control of Cal-Ore. We recognize, however, that key owners of Cal-Ore are in poor health and need to transfer ownership of Cal-Ore to new hands as soon as possible. Although we will approve the Application, we place the Joint Applicants on notice that we will not tolerate another instance of their failure to provide material and relevant information sought by the Commission pursuant to its authority under §§ 314(b), 581 *et seq.*, 701, and 791 *et seq.*, Condition No. 11 in Appendix D of this Decision, and other relevant law. If any of the Joint

[32] The ALJ made a technical correction to the ruling in an e-mail sent to the Joint Applicants on November 3, 2004.

Applicants again fails to provide material and relevant information, we intend to impose the maximum fine allowed by §§ 2107 and 2113 and other relevant law.

D. Fair and Reasonable to the Affected Utility Employees

i. Background

In deciding whether it is in the public interest to authorize the transfer of a public utility, the Commission may consider if the proposed transfer is fair and reasonable to the affected utility employees. Among the factors the Commission may consider is whether and how the proposed transfer will affect employees' jobs, pay, and benefits.[33]

The Joint Applicants state that the transaction will not initially result in any change in compensation and benefits of non-shareholder employees. They also state that the transaction will cause no reduction in Cal-Ore's workforce other than the elimination of shareholder employees. The Joint Applicants contend that employees will have access to improved opportunities for training and career advancement because they will be a part of a much larger family of companies. Lynch reserves the right, however, to adjust employee compensation and the size of the workforce in response to changing economic conditions.

ii. Discussion

We conclude for the following reasons that Lynch's acquisition of Cal-Ore will be fair and reasonable to utility employees. First, none of Cal-Ore's employees participated in this proceeding. This suggests that the affected employees believe the proposed sale is fair and reasonable. Second, the Stock Purchase Agreement appended to A.04-05-039 states that it is Lynch's intent "to offer continued employment to COTC Company's non-shareholder employees

[33] D.01-06-007, 2001 Cal. PUC LEXIS 390, *104.

on substantially the same terms as they have with COTC companies as of the Closing Date.[34]" This shows that Lynch intends to act in a way that is fair and reasonable to Cal-Ore's employees. Finally, the Joint Applicants represent that Lynch's purchase of COTC will not initially affect the compensation or benefits of any non-shareholder employees of Cal-Ore; that there will not be an immediate reduction in the number of non-shareholder employees; that all current Cal-Ore jobs will remain in the local community, and that Cal-Ore employees will have access to better training and career opportunities because they will be part of a much larger company. These representations provide additional evidence that Lynch intends to act in a way that is fair and reasonable to Cal-Ore's employees.

E. Fair and Reasonable to a Majority of Utility Stockholders

i. Background

In deciding whether it is in the public interest to authorize the transfer of a public utility, the Commission may consider if the proposed transfer is fair and reasonable to a majority of the affected utility shareholders. In considering this matter, the Commission does not focus on whether the buyer or seller has made a good deal. Rather, the Commission considers if all pertinent information regarding the proposed transfer has been disclosed to shareholders, and if a majority of shareholders support the transaction.[35]

The Joint Applicants state that because the proposed transaction has been approved by COTC's shareholders, the transaction is fair and reasonable to shareholders.

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[34] A.04-05-039, Exhibit 2, p. 22.

[35] D.01-06-007, 2001 Cal. PUC LEXIS 390, *109.

ii. Discussion

We conclude for the following two reasons that the proposed transaction is fair and reasonable to a majority of COTC's and Lynch's shareholders. First, the shareholders have been notified about the proposed transaction. Lynch provided notice of the proposed transaction in its annual report to shareholders,[36] and COTC's shareholders have signed the lengthy and detailed sales agreement.[37] There is no record in this proceeding of any shareholder opposition to the transaction. Second, the proposed transaction is an arms-length agreement, which suggests that the transaction is fair and reasonable to most shareholders.

F. Beneficial to State and Local Communities

i. Background

In deciding whether it is in the public interest to authorize the transfer of a public utility, the Commission may consider if the proposed transfer will be beneficial on an overall basis to the (1) State and local economies, and (2) communities served by the resulting public utility. In considering this matter, the Commission focuses primarily on the economic effects of the proposed transaction, but the Commission may consider other factors as well.[38]

The Joint Applicants assert that the proposed transaction will benefit the local communities served by Cal-Ore and California generally because Cal-Ore will have better access to capital with which to make future investments. The additional investment will help Cal-Ore to provide a full range of advanced

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[36] A.04-05-039, Exhibit 6.

[37] A.04-05-039, Exhibit 1. The proceeds from the sale will be allocated among COTC's shareholder's in accordance with the percentage allocations to be specified in writing by the shareholders in an amendment to the Stock Purchase Agreement that will be provided by the shareholders prior to closing. (Id., Section 1.2.)

[38] D.01-06-007, 2001 Cal. PUC LEXIS 390, *113.

telecommunications services. The proposed transaction will also retain jobs in the communities served by Cal-Ore, and new jobs might be added.[39] The Joint Applicants expect that the Commission, in its continuing jurisdiction over Cal-Ore's rates and services, will ensure that Cal-Ore's ratepayers receive an equitable allocation of the future benefits of the transaction.

ii. Discussion

Although the Joint Applicants offer vague statements about possible benefits the proposed transaction might bring to California and the communities served by Cal-Ore, the record of this proceeding demonstrates the transaction could result in a reduction in Cal-Ore's capital expenditures and service quality. Elsewhere in this Decision, we adopt various conditions to protect the public interest, such as the condition that Cal-Ore must maintain capital expenditures at a level equal to its depreciation expense. With the adoption of these conditions, we conclude that the proposed transaction will not harm the State and local economies or the communities served by Cal-Ore.[40]

G. Preserve the Jurisdiction of the Commission

i. Background

In deciding whether it is in the public interest to authorize the transfer of a public utility, the Commission may consider if the proposed transfer will preserve (1) the jurisdiction of the Commission, and (2) the capacity of the Commission to effectively regulate and audit public utility operations.[41]

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[39] A.04-05-039, pp. 8, 10, and 11.

[40] It is possible that Lynch's access to capital markets may redound to the benefit of the local communities served by Cal-Ore after Lynch has paid off a significant portion of the debt it incurs to acquire COTC. However, that benefit appears to be years away.

[41] D.01-06-007, 2001 Cal. PUC LEXIS 390, *119.

The Joint Applicants assert that the transaction will preserve the jurisdiction of the Commission because Cal-Ore will continue to operate as a telephone service utility subject to the Commission's regulation.

ii. Discussion

We find that the proposed transaction will have no adverse effect on our jurisdiction or our capacity to effectively regulate and audit Cal-Ore. After the transaction is complete, the Public Utilities Code and all Commission decisions and General Orders will continue to apply to Cal-Ore. For example, after the sale is complete, Cal-Ore must continue to (1) maintain such books and records as the Commission may require to effectively regulate and audit Cal-Ore; and (2) provide the Commission with such information as the Commission may require to effectively regulate and audit Cal-Ore.[42]

We are concerned, however, about access to information held by Lynch. The record of this proceeding shows that Lynch can and will withhold information from the Commission. To the extent that Lynch makes decisions that affect Cal-Ore or retains records related to Cal-Ore, failure by Lynch to cooperate with the Commission could impede the Commission's ability to effectively oversee, regulate, and audit Cal-Ore. Therefore, we will approve A.04-05-039 with the condition that the Commission will have access to information and documents held by COTC, Lynch, and other affiliates to the same extent the Commission has access to information and documents held by Cal-Ore.

[42] §§ 581 *et seq.*, 701, and 791 *et seq.*

H. Competitive Effects

i. Background

In deciding whether it is in the public interest to authorize the transfer of control of a public utility, the Commission must consider whether and how the proposed transfer might affect competition. The Commission is not strictly bound by antitrust laws. The Commission can approve actions that otherwise violate antitrust laws when other economic, social, or political factors are found to be of overriding importance. In addition, the Commission does not need to choose another course of action if the chosen course has anti-competitive effects, as long as the chosen course of action is in the public interest.[43] The Commission may also reject transactions that do not violate antitrust laws.

The Joint Applicants state that the proposed transaction will not affect competition because Cal-Ore will continue to serve the same geographic area.[44]

ii. Discussion

Based on our review of the record of this proceeding, we conclude that the proposed transaction does not raise any antitrust or anticompetitive issues that warrant our intervention.

I. Approval of the Proposed Transaction

We conclude for the following reasons that it is reasonable to grant authority under § 854(a) to transfer indirect control of Cal-Ore to Lynch. First, the transfer will not affect Cal-Ore's ratepayers because there will be no change to Cal-Ore's name, local management, operations, utility rates, or services.

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[43] D.01-06-007, 2001 Cal. PUC LEXIS 390, *122.

[44] The Joint Applicants assert that no filing was necessary under the federal Hart-Scott-Rodino Act. (Supplement filed July 30, 2004, p. 16.)

Second, this Decision adopts numerous conditions to prevent any potential adverse impacts that the transaction might have on the public interest. With these conditions, we conclude that the public will not be harmed by the transaction. Third, the public might benefit from the transaction if it enhances Cal-Ore's ability to raise capital as the Joint Applicants allege. This could help Cal-Ore to maintain, improve, and expand its services in California. Finally, California reaps enormous benefits from the services provided by public utilities. Thus, it is in the public interest to foster a business climate in California that is hospitable to utilities. Accordingly, transactions that are subject to § 854(a) should be approved absent a compelling reason to the contrary. With the conditions adopted by this Decision, we are not aware of any reason why the transaction should not be approved.

J. Gain on Sale

i. Background

Lynch intends to purchase COTC for $21.2 million.[45] The shareholders of COTC will realize a net gain from the sale of COTC equal to the sales price of $21.2 million less any taxes, transaction costs, contingent adjustments to the purchase price, and the shareholders' investment in COTC.[46] The Joint Applicants argue that Commission precedent and court decisions require that COTC's shareholders receive the entire gain from the sale of COTC.

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[45] A.04-05-039, Exhibit A, page 1.

[46] There is no record in this proceeding regarding the amount of the shareholders' gain.

ii. Discussion

In situations involving the sale of an entire utility, as is the case here, we have always allocated to shareholders the gain or loss from the sale.[47] Therefore, consistent with our precedent, we will allocate to COTC's shareholders the entire gain from the sale of Cal-Ore.[48]

The approach that the Commission has taken in allocating gain-on-sale should not be confused with the allocation of other benefits from a transaction. With respect to certain transactions (not including this one), § 854(b)(2) requires that ratepayers receive an equitable allocation of the transaction's benefits. Even in transactions not explicitly covered by § 854(b)(2) the Commission has sometimes allocated a portion of the transaction benefits to ratepayers. However, those cases did not involve an allocation of any gain on sale. They involved a quantification of economic benefits of a transaction and an allocation of an equitable share of those benefits to ratepayers. Because Cal-Ore is a cost-of-service utility the Commission will be able to pass the economic benefits of the transaction, if any, to ratepayers through normal ratemaking processes. Thus, there is no need at this time to identify and allocate the transaction benefits.[49]

We recognize that Cal-Ore has received ratepayer-funded subsidies from intercompany settlements and, more recently, the California High Cost Fund A (CHCF-A). These subsidies were included in Cal-Ore's revenue requirement and used to recover its cost of service. If these subsidies had not been available,

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[47] D.01-06-007, 2001 Cal. PUC LEXIS 390, *154.

[48] The public might also receive a portion of the gain via the taxes that the owners of COTC may have to pay on the gain.

[49] Cal-Ore's next general rate case filing should separately identify and describe the economic benefits of the transaction, if any, so that the benefits may be flowed through to ratepayers.

Cal-Ore would have had to recover its revenue requirement from its customers. Thus, the subsidies ultimately flowed to Cal-Ore's customers, since Cal-Ore' customers received telephone service at rates well below the cost of providing that service. There was no windfall for Cal-Ore's shareholders, and the subsidies that flowed directly to Cal-Ore's ratepayers did not provide ratepayers with an ownership interest in Cal-Ore.

We emphasize that we may impose conditions on the sale of a public utility pursuant to our authority under §§ 701, 851, and 854 to ensure that the sale is in the public interest. Therefore, when necessary, we may allocate some or all of the gain from the sale of a public utility to fund measures that are intended to mitigate or prevent actual or potential adverse impacts that a sale might have on the public interest.[50] In the case before us here, it is not necessary to fund any such measures. Accordingly, all the gain-on-sale should be allocated to shareholders in accordance with longstanding precedent.

7. Authority to Transfer Indirect Control of Cal-Ore Long Distance, Inc.

Cal-Ore Long Distance, Inc. (COLD), which is owned by COTC, is authorized to provide resold interexchange services in California pursuant to D.01-04-002. In A.04-05-039, the Joint Applicants request authority under § 854(a) for Lynch to acquire indirect control of COLD.[51]

Lynch does not possess a Certificate of Public Convenience and Necessity (CPCN) to provide telecommunications services in California. In situations where a company acquiring a telecommunications utility does not possess a CPCN, the Commission requires the acquiring entity to satisfy the same criteria

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[50] D.89-07-016, 32 CPUC 2d 233, 235.

[51] Supplement filed July 30, 2004, p. 19.

as an applicant seeking a CPCN to exercise the type of authority held by the utility being acquired.

Lynch must satisfy four requirements to obtain a CPCN like that held by COLD. First, Lynch must have a minimum of $ 25,000 in cash or cash equivalent. Application 04-05-039 contains pieces of Lynch's financial statements, and the included pieces demonstrate that Lynch has more than $25,000 in cash.[52]

Second, Lynch must have demonstrated technical expertise in the operation of a telecommunications utility or related business. Lynch satisfies this requirement due to its ownership of 14 rural ILECs.

Third, Lynch should not have a history of regulatory misconduct, business malfeasance, or business incompetence. In response to a routine inquiry from the Commission, Lynch represents that no affiliate, officer, director, partner, or owner of more than 10% of any of the Lynch companies, or any person acting in that capacity, has been (1) sanctioned by the Federal Communications Commission (FCC) or a state regulatory commission for violating a regulatory statute, rule, or order[53]; or (2) found criminally or civilly liable for a violation of § 17000 *et seq.* of the California Business and Professions Code or for misrepresentations to consumers, or is currently under investigation for such misconduct.[54] Lynch also noted in its response that two of its officers have been associated with companies that have filed bankruptcy. First, in September 1999,

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[52] A.04-05-039, Exhibit 5.

[53] Lynch notes that Gabelli Funds, Inc. (GFI), a registered investment advisor, and Mario J. Gabelli, the CEO of GFI and the current CEO of Lynch Interactive, entered into a consent agreement in 1993 with the FCC pursuant to which, without admitting any violation and without the impositions of any fines or other sanctions, they agreed to comply with certain FCC regulations with respect to the media interests of GFI's clients.

[54] Supplements filed on February 10 and 14, 2005.

Lynch Corporation spun off Lynch Interactive Corporation to its shareholders. The current CEO of Lynch Interactive remained on the Board of Directors of Lynch Corporation after the spin-off. At the time of the spin-off, Lynch Corporation owned 60% of Spinnaker Industries, Inc (Spinnaker).[55] Spinnaker filed for bankruptcy in November 2001. Second, Lynch Interactive spun off Morgan Group, Inc. (Morgan) in January 2002.[56] Morgan filed for bankruptcy in October 2002. One current officer of Lynch Interactive was a director of Morgan when it filed for bankruptcy.

Finally, the Commission considers if the proposed transaction will adversely affect the customers of the utility being acquired. The Joint Applicants represent that the proposed transaction will not result in a change to COLD's name, management, or the rates, terms, and conditions of services offered by COLD. Based on this information, we concluded that COLD's existing customers will not be adversely affected by the proposed transaction.

We find that the proposed transfer of control of COLD to Lynch satisfies the Commission's requirements. Although two of Lynch's officers were associated with bankrupt companies, there is no evidence in this proceeding that the bankruptcies were caused by management incompetence or malfeasance. These circumstances lead us to conclude that Lynch's acquisition of COLD should not be rejected just because two of Lynch's officers have been associated with bankrupt companies. Therefore, we will approve the transfer.

[55] Spinnaker manufactured adhesive paper for postage stamps and other pressure sensitive labels. The bankruptcy terminated with the liquidation of Spinnaker. Equity owners received zero value for their equity.

[56] Morgan specialized in the transportation of manufactured homes and recreational vehicles.

8. Environmental Assessment

a. Background

Pursuant to the California Environmental Quality Act (CEQA)[57] and Rule 17.1 of the Commission's Rules of Practice and Procedure (Rule), we must consider the environmental consequences of projects that are subject to our discretionary approval. Thus, in deciding whether to approve A.04-05-039, we must consider if doing so will alter an approved project, result in new projects, change facility operations, etc., in ways that have an environmental impact. The Joint Applicants state that because the proposed transaction involves only a change in ownership of COTC, there is no possibility that the transaction will have any significant adverse effect on the environment.

b. Discussion

The record of this proceeding indicates that approval of A.04-05-039 will not have a significant effect on the environment. In particular, the Application does not request authority for new construction, and the Joint Applicants represent that they have no plans to undertake new construction, change the operations of COTC or its subsidiaries, or change the use of existing assets and facilities.[58] Therefore, it can be seen with certainty that the proposed transaction will not have a significant effect on the environment and, for this reason, qualifies for an exemption from CEQA pursuant to Section 15061(b)(3)(1) of the CEQA guidelines.[59] Consequently, there is no need for further environmental review.

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[57] Pub. Res. Code § 21080.

[58] Supplement filed July 30, 2004, p. 15.

[59] Section 15061(b)(3)(1) of the CEQA guidelines states: "Where it can be seen with certainty that there is no possibility that the activity in question may have a significant effect on the environment, the activity is not subject to CEQA."

Of course, if the Joint Applicants decide in the future to undertake any new construction, change the operations of COTC or its subsidiaries, or change the use of Cal-Ore's existing assets and facilities, the Joint Applicants will have to fully comply with any applicable CEQA requirements.

9. Comments on the Draft Decision

The draft Decision of the assigned ALJ was mailed to the service list in accordance with § 311(g)(1) and Rule 77.7. Comments on the draft decision were filed on March 23, 2005, by Lynch and jointly by Cal-Ore and COTC. There were no reply comments. These comments have been reflected, as appropriate, in the final Decision adopted by the Commission.

10.Categorization and Need for Hearings

In Resolution ALJ 176-3135, dated June 9, 2004, the Commission preliminarily categorized this proceeding as ratesetting and preliminarily determined that hearings were not necessary. Based on the record of this proceeding, we affirm and finalize the determinations regarding categorization and the need for hearings that were made in Resolution ALJ 176-3135.

11.Assignment of Proceeding

Geoffrey F. Brown is the Assigned Commissioner and Timothy Kenney is the assigned ALJ in this proceeding.

Findings of Fact

1. COTC is a holding company that owns Cal-Ore and COLD. Cal-Ore represents the vast bulk of COTC's revenues and a majority of COTC's assets.

2. Cal-Ore is a small ILEC with approximately 2,600 access lines. Cal-Ore had $5.3 million of revenues during 2003.

3. Lynch Interactive is a publicly held company that owns 14 small ILECs in nine states outside of California. It had $87.5 million of revenues in 2003.

4. Application 04-05-039 requests authority under § 854(a) for Lynch to purchase COTC in accordance with the Stock Purchase Agreement appended to A.04-05-039. If approved, the transaction will result in Lynch obtaining control of Cal-Ore and COLD.

5. In the Stock Purchase Agreement, Lynch has agreed to purchase COTC for $21.2 million of cash and promissory notes. The cash portion will be $14 million, and the promissory notes will total $7.2 million.

6. The Joint Applicants represent that the purchase of COTC by Lynch will not result in (i) the sale or disposal of any material public utility assets, or (ii) changes to any of the following: (a) the rates, terms, or conditions for any utility service, (b) the manner in which any utility service is provided, (c) the book value of Cal-Ore property dedicated to public service, and (d) the management, managers, and operation of Cal-Ore.

7. Lynch intends to purchase COTC using 100% debt financing.

8. The $21.2 million of debt incurred by Lynch to acquire COTC would be in addition to COTC's existing long-term debt, which amounted to $6.5 million on December 31, 2003. Cal-Ore accounts for most or all of COTC's long-term debt.

9. Lynch's purchase of COTC for $21.2 million using 100% debt financing will negatively affect the financial condition of Lynch, COTC, and Cal-Ore because COTC and its subsidiaries do not generate enough cash to pay for the cost of the debt used to acquire COTC while continuing to fund Cal-Ore's operations, maintenance, repairs, and capital additions at a historical level.

10. The only way for COTC to generate enough cash to pay for the debt incurred by Lynch to acquire COTC is for Cal-Ore to cut expenditures for operations, maintenance, repairs, and/or capital additions.

11. For the reasons set forth in the two previous Findings of Fact (FOF), Lynch will have a strong financial incentive to cause Cal-Ore to cut expenditures for operations, maintenance, repairs, and/or capital additions. If this occurs, the quality of service offered by Cal-Ore could deteriorate over time.

12. It is possible that after Cal-Ore is acquired by Lynch, Cal-Ore could reduce capital expenditures in a way that reduces net plant-in-service without any adverse effect on service quality.

13. The conditions adopted by this Decision are necessary to maintain the quality of service provided by Cal-Ore if A.04-05-039 is approved.

14. The technical competence of Cal-Ore's management will be maintained and possibly improved by Lynch's acquisition of COTC.

15. The Joint Applicants initially refused and then failed to provide information required by three separate ALJ rulings. These ALJ rulings directed the Joint Applicants to explain how COTC would generate enough cash to pay for (i) the cost of the debt incurred by Lynch to acquire COTC, and (ii) historical levels of maintenance and capital expenditures.

16. The Joint Applicants' willful disregard of ALJ rulings that is described in the previous FOF raises serious concerns about the fitness of Lynch to acquire indirect control of Cal-Ore and COLD.

17. Because of the Joint Applicants failed to cooperate fully with the Commission in this proceeding, the willingness and ability of Cal-Ore's management to comply with Commission requirements may deteriorate if Lynch acquires indirect control of Cal-Ore.

18. Lynch did not conduct an analysis of how much money it might earn or lose from its investment in COTC. The failure to conduct such an analysis raises questions about the quality of Lynch's management.

19. The conditions adopted by this Decision are necessary to maintain the overall quality of Cal-Ore's management if A.04-05-039 is approved.

20. This Decision places the Joint Applicants on notice that they must provide information to the Commission pursuant to its authority under all relevant law, including, but not limited to, Condition 11 in Appendix D of this Decision and §§ 314(b), 581 *et seq.*, 701, and 791 *et seq.* If any of the Joint Applicants fails to provide material and relevant information, the Commission intends to impose the maximum fine allowed by §§ 2107 and 2113 and other relevant law.

21. The Commission has received no complaints or expressions of concern from Cal-Ore employees regarding the sale of COTC.

22. The Joint Applicants represent that Lynch's purchase of COTC will not initially affect the compensation or benefits of any of the non-shareholder employees of Cal-Ore, and that the transaction will provide Cal-Ore employees with access to better training and career opportunities because they will be a part of a much larger family of companies.

23. The Joint Applicants represent that Lynch's purchase of COTC will not result in an immediate reduction in the number of Cal-Ore's non-shareholder employees, and that all current Cal-Ore jobs will remain in the local community.

24. The Stock Purchase Agreement appended to A.04-05-039 states that it is Lynch's intent to offer continued employment to COTC's non-shareholder employees on substantially the same terms in effect as of the Closing Date.

25. The proposed transaction is fair and reasonable to Cal-Ore's employees for the reasons set forth in the four previous FOFs.

26. The proposed transaction has been approved by COTC's shareholders.

27. Lynch has provided notice of the proposed transaction in its annual report to its shareholders.

28. There is no evidence in the record of this proceeding of any shareholder opposition to the proposed transaction.

29. The proposed transaction is an arms-length agreement.

30. The proposed transaction is fair and reasonable to a majority of Lynch's and COTC's shareholders for the reasons set forth in the four previous FOFs.

31. The record of this proceeding demonstrates that the proposed transaction could result in a reduction in Cal-Ore's expenditures for operations, maintenance, repairs, and infrastructure. If this occurred, it would not be beneficial to the State and local economies or the communities served by Cal-Ore.

32. The conditions adopted by this Decision will help to ensure that the proposed transaction does not harm the State and local economies or the communities served by Cal-Ore.

33. There is no evidence in the record of this proceeding that the proposed transaction will adversely affect competition.

34. If A.04-05-039 is approved, the shareholders of COTC will realize a net gain from the sale of COTC equal to the sales price of $21.2 million less any taxes, transaction costs, contingent adjustments to the purchase price, and the shareholders' investment in COTC. There is no record in this proceeding regarding the amount of the shareholders' gain.

35. There is no evidence that ratepayers contributed capital to Cal-Ore.

36. COLD is authorized to provide interexchange service in California pursuant to D.01-04-002. Lynch does not have a CPCN to provide telecommunications services in California.

37. Lynch has a minimum of $25,000 in cash or cash equivalent.

38. Lynch has sufficient technical expertise to assume control of COLD.

39. The Joint Applicants represent that no affiliate, officer, director, partner, or owner of more than 10% of any Lynch entity, or any person acting in that capacity, has filed for bankruptcy or been sanctioned by the FCC or any state regulatory commission for failure to comply with any regulatory statute, rule or order; and that no such entity or person has been found criminally or civilly liable for a violation of § 17000 *et seq*. of the California Business and Professions Code or for any actions that involved misrepresentations to consumers, or is currently under investigation for similar violations.

40. The proposed transaction will not result in a change to COLD's name, management, or the rates, terms and conditions of services offered by COLD.

41. Lynch satisfies the Commission's requirements for a CPCN to provide resold interexchange services.

42. Application 04-05-039 does not request, and this Decision does not authorize, authority for new construction or for any changes in the use of existing assets and facilities.

43. The Joint Applicants represent that approval of A.04-05-039 will not result in any changes to Cal-Ore's or COLD's operations or use of existing assets.

44. There were no protests or other responses to A.04-05-039.

Conclusions of Law

1. This is a ratesetting proceeding.

2. There is no need for an evidentiary hearing.

3. Pursuant to § 854(a), no person or corporation may merge, acquire, or control a public utility organized and doing business in California without first securing authorization to do so from the Commission.

4. The purpose § 854(a) is to enable the Commission to review a proposed transaction, before it takes place, in order to take such action as the public interest

may require. Where necessary, the Commission may attach conditions to a transaction in order to protect and promote the public interest.

5. Application 04-05-039 is subject to § 854(a). The Commission has broad discretion under § 854(a) to approve or reject A.04-05-039.

6. To protect the public from the possible adverse consequences that approval of A.04-05-039 might have on Cal-Ore, and to ensure that Cal-Ore's customers continue to receive adequate service at reasonable rates, approval of A.04-05-039 should be subject to the conditions identified in Appendix D.

7. There will be no adverse effect on the Commission's jurisdiction or the Commission's capacity to effectively regulate and audit Cal-Ore's public utility operations if A.04-05-039 is approved with the conditions in Appendix D.

8. Approval of A.04-05-039 does not raise any antitrust or anticompetitive issues that warrant the Commission's intervention.

9. Application 04-05-039 should be granted with the conditions identified in Appendix D.

10. If Cal-Ore wishes to reduce its net plant-in-service by spending less on capital expenditures than its depreciation expense, Cal-Ore should have the burden of demonstrating why a reduction of its public utility infrastructure is reasonable and does not harm the public interest.

11. Cal-Ore should be authorized to file a petition to modify this Decision to obtain an after-the-fact waiver of Condition No. 6 in Appendix D. Any such petition should (i) be filed in 2010; (ii) demonstrate that the decline in Cal-Ore's net plant-in-service reported in conformance with the Uniform System of Accounts during 2005 – 2009 was reasonable and did not harm the public interest; and (iii) contain (a) GO 133-B data for each of the years 2003 – 2009, (b) total depreciation expense (interstate and intrastate) for each of the years

2005 – 2009 and the cumulative depreciation expense during 2005 - 2009, and (c) total capital expenditures for each of the years 2005 – 2009 and the cumulative capital expenditures for 2005 - 2009. If the Commission finds that Cal-Ore's ratepayers were harmed by Cal-Ore's decision to spend less for capital expenditures than required by today's Decision, the Commission may find that Cal-Ore has failed to comply with today's Decision and take such actions as warranted by the circumstances.

12. Cal-Ore's next general rate case filing should separately identify and describe the economic benefits, if any, of the transaction described in A.04-05-039 and approved by this Decision.

13. The gain from the sale of COTC should accrue to shareholders in accordance with the precedent established by D.01-06-007 *et al.*

14. Because approval of A.04-05-039 will not have an adverse effect on the environment, the proposed transaction qualifies for an exemption from CEQA pursuant to Section 15061(b)(3)(1) of the CEQA guidelines. Consequently, there is no need for further environmental review of the proposed transaction.

15. The following Order should be effective immediately so that the indirect transfer of control of Cal-Ore and COLD can be completed promptly.

O R D E R

IT IS ORDERED that:

1. Pursuant to Pub. Util. Code § 854, the request for authority to transfer indirect control of Cal-Ore Telephone Co. (Cal-Ore) and Cal-Ore Long Distance, Inc. (COLD), to Lynch Interactive Corporation *et al.* (Lynch) that is set forth in Application (A.) 04-05-039 and the Stock Purchase Agreement appended to A.04-05-039 is granted.

2. This authority granted by this Order is subject to the conditions set forth in Appendix D.

3. The authority granted by this Order shall expire if not exercised within one year from the effective date of this Order.

4. Cal-Ore and COLD shall file with the Commission's Docket Office, for inclusion in the formal file of A.04-05-039, written notice of when the indirect transfer of control of each of these companies has taken place. This notice shall be filed no later than 30 days after the transfer.

5. Cal-Ore may file a petition to modify this Decision for the purpose of obtaining an after-the-fact waiver of Condition No. 6 in Appendix D of this Decision. Any petition filed pursuant to this Ordering Paragraph shall (i) be filed in 2010, (ii) demonstrate that the decline in Cal-Ore's net plant-in-service reported in conformance with the Uniform System of Accounts during 2005 – 2009 was reasonable and did not harm the public interest; and (iii) contain (a) General Order 133-B data for each of the years 2003 – 2009, (b) total depreciation expense (interstate and intrastate) for each of the years 2005 – 2009 and the cumulative depreciation expense during 2005 - 2009, and (c) total capital expenditures for each of the years 2005 – 2009 and the cumulative capital expenditures for 2005 - 2009.

6. The gain from the sale of Cal-Ore shall accrue to shareholders.

7. Cal-Ore's next general rate case filing shall separately identify and describe the economic benefits, if any, of the transaction approved by this Order so that the benefits may be flowed through to Cal-Ore's ratepayers.

8. Application 04-05-039 is closed.

This Order is effective today.

Dated _________________, at San Francisco, California.

Appendix A

SURPLUS/(DEFICIT) OF CASH AVAILABLE FOR CAPITAL EXPENDITURES

Appendix B

HISTORICAL DEPRECIATION COSTS AND CAPITAL EXPENDITURES

Appendix C

COTC AND CAL-ORE HISTORICAL
CASH FLOW FROM OPERATIONS

Appendix D
Adopted Conditions

The authority granted by this Decision is subject to following conditions:

1. Lynch Interactive Corporation (Lynch) and California-Oregon Telecommunications Co. (COTC) shall provide Cal-Ore Telephone Company (Cal-Ore) with sufficient equity capital to enable Cal-Ore to (i) maintain a reasonable and balanced capital structure, and (ii) provide service to the public that is safe, reliable, and in compliance with all applicable statutes and Commission orders.
2. Cal-Ore shall manage its finances on a stand-alone basis, independent of COTC, Lynch, and other affiliates.
3. Cal-Ore shall not loan money, pay a dividend, pay a management fee, or transfer other money to Lynch, COTC, or other affiliates if doing would (i) jeopardize Cal-Ore's ability to provide safe and reliable service to the public at reasonable rates, or (ii) contravene any applicable laws, including the State Constitution, the Public Utilities Code, or any Commission order, decision, decree, rule, direction, demand, or requirement.
4. Cal-Ore shall not record a premium for regulatory accounting purposes, where the premium is the excess of purchase price over book value.
5. Cal-Ore shall not recover in its rates, charges, and fees for intrastate services any (i) costs associated with the premium; (ii) costs associated with the sale / purchase of COTC; (iii) costs caused by negative synergies or diseconomies of scale associated with the sale / purchase of COTC; or (iv) any other negative financial impacts associated with the transaction.

6. For the five-year period beginning on January 1, 2005, Cal-Ore's capital expenditures shall equal or exceed Cal-Ore's depreciation expense during the same period. To provide flexibility, Cal-Ore's capital expenditures in any given year may be more or less than its deprecation expense for the year, as long as (i) the capital expenditures during any year equal at least 33% of the depreciation expense for that year, and (ii) the cumulative capital expenditures during the five-year period equal 100% of the cumulative deprecation expense during the five-year period.
7. Regardless of the amount of debt that Lynch and COTC may decide to allocate to Cal-Ore, the Commission may impute a reasonable and balanced capital structure for Cal-Ore for regulatory accounting and ratemaking purposes.
8. No later than 90 days after the transfer of control is complete, Lynch shall use COTC's and Cal-Ore's existing cash and liquid financial assets to retire all of COTC's and Cal-Ore's existing long-term debt or, alternatively, retire a portion of the debt incurred by Lynch to acquire COTC equal to COTC's and Cal-Ore's existing long-term debt.
9. Except as specified in Condition 8, the assets of Cal-Ore shall not be pledged to pay or guarantee the debt of Lynch or any subsidiary or affiliate of Lynch without prior approval from the Commission.
10. The acquisition of COTC by Lynch shall have no adverse effect on Cal-Ore's service quality. If Cal-Ore's service quality deteriorates prior to January 1, 2010, Cal-Ore shall have the burden of demonstrating that the deterioration was not caused by, or related to, Lynch's acquisition of COTC. If the Commission finds that the acquisition has contributed to a deterioration of service quality, then Cal-Ore and Lynch may be subject to all remedies legally available to the Commission, including, but not limited to, monetary penalties under § 2107 for having violated this Decision.
11. The Commission shall have access to information and documents held by COTC, Lynch, and other affiliates to the same extent the Commission has access to information and documents held by Cal-Ore.

(END OF APPENDIX D)